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Contents

COST OF CAPITAL CONTROVERSIES

Part I: It's Time to Look Behind the Curtain

By James R. Hitchner, CPA/ABV, ASA and Katherine E. Morris

The determination of the cost of capital for a business is fraught with controversy. Many valuation analysts find safety and comfort in using data sources that are widely recognized. These data sources are indeed helpful, but analysts should understand thoroughly how the data is derived, what choices there are in selecting such data and what the strengths and weaknesses of the data are. This article is the first in a four-part series that deals with all the components of the Weighted Average Cost of Capital (WACC).

In calculating the WACC of a closely held company, the analyst must make choices in five major categories. We know that the WACC formula, excluding preferred stock, is as follows:

$$\text{WACC} = \text{Wd} \times \text{dpt}\,(1 - \text{tax rate}) + \text{We} \times \text{ke}$$

We also know that ke (the required rate of return for a company's equity capital) for a small to medium-sized closely held company is usually derived by using either the Modified Capital Asset Pricing Model (MCAPM) or the Build Up Model (BUM). Let's focus on MCAPM first. The WACC equation is now expanded as follows:

$$\text{WACC} = [\text{Wd} \times \text{dpt}\,(1 - \text{tax rate})] + [\text{We} \times \underbrace{(\text{Rf} + \text{B}\,(\text{RPm}) + \text{RPs} + \text{Rpu})}_{\text{MCAPM}}]$$

For the BUM we have:

$$\text{WACC} = [\text{Wd} \times \text{dpt}\,(1 - \text{tax rate})] + [\text{We} \times \underbrace{(\text{Rf} + \text{RPm} + \text{RPs} + \text{Rpu} + \text{Rpi})}_{\text{BUM}}]$$

Under both equations, the analyst must make decisions on nine categories that have a direct influence on the WACC and thus on value. The difference is that beta is used in the MCAPM, and some analysts use an industry risk premium in the BUM. Nothing is new here in terms of the categories. Plenty is new, however, in the choices to determine the amount that goes into each category. Before we get into those choices, which are the main focus of this article, let's define the above-mentioned categories of the WACC.

Wd	**Fair market weight of debt in the capital structure**
dpt	**Pre-tax cost of debt**
Tax rate	**Company-specific tax rate**
We	**Fair market weight of common equity in the capital structure**
Rf	**Risk free rate of return**
Beta	**Measure of risk using volatility**
RPm	**Risk premium in the marketplace**
RPs	**Risk premium adjusted for size, also known as size premium**
Rpu	**Risk premium for unsystematic risk, also known as specific company risk**
Rpi	**Risk premium for the industry**

These equations and the categories that make them up are fairly simple to use. However, as is often the case in valuation, the devil is in the details.

Equity risk premiums (RPm, RPs, and RPi) based on historical stock market return data are widely accepted and relied upon by the valuation community. The most prominent publisher of such data is Ibbotson Associates. (See *Stocks, Bonds, Bills, and Inflation, SBBI, Valuation Edition, 2004 Yearbook,* Ibbotson Associates, Chicago, IL.) Standard & Poor's also relies on historical data to calculate the small company risk premiums that it publishes in its Risk Premium Report. (See *Standard & Poor's Corporate Value Consulting Group Risk Premium Report 2003,* published by Standard & Poor's Corporate Value Consulting, a division of the McGraw-Hill Companies.) In the January/February 2003 *Financial Analysts Journal,* Roger G. Ibbotson and Peng Chen developed a supply side analysis of equity risk premium based on fundamental market data (See "Long-Run Stock Returns: Participating in the Real Economy," Volume 59, No. 1, Association for Investment Management and Research).

In part two of this article, we will address the differences between the use of Ibbotson and Standard & Poor's data for both RPm and RPs and the new supply side equity risk premium. In parts three and four of this article, we will focus on the industry risk premium, beta, the cost of debt, taxes, specific company risk, and the weights in the WACC. For now, we will focus on an analysis of Ibbotson data as it pertains to Rf and RPs.

MARKETPLACE RISK

First we'll take an easy one, Rf. Most analysts use the return on a U.S. 20-year treasury bond, which is a 30-year bond with 20 years remaining. Why 20 years instead of, say five years or even 30 days? Twenty years is what Ibbotson Associates, in their annual *Valuation Edition Yearbook,* use to calculate the long-horizon equity risk premium, RPm. Analysts prefer to stay consistent with Ibbotson's use of the data. Furthermore, the 20-year investment term is the most similar to the long-term investment horizon of a closely held company. Remember, under fair market value, the horizon is usually that of the investment, not the investor, which may be more of an investment value.

Does it make a difference whether we use 20 years (long-term), five years (intermediate-term) or 30 days (short-term)? Let's take a look. Consider the following calculations that use treasury rates as of May 3, 2004. The equity risk premiums for long, intermediate, and short horizon risk premiums in the sidebar below are from the last page of Ibbotson Associates' *SBBI Valuation Edition 2004 Yearbook.*

As can be seen, the difference in returns from the 20-year bond is smaller when compared with a five-year bond and much greater when compared with a 30-year bill. This is due to the yield curve on treasury securities and the impact of investor horizon risk on the five-year and 20-year bonds versus the 30-day bill. There are also differences in CAPM with a higher or lower beta as compared with returns using the BUM. The differences are larger when a lower beta is used. We believe this example illustrates the importance of using long-term risk free rates and the 20-year-horizon risk premium using Ibbotson data.

SIZE RISK

Let's take a hard one now, RPs. Did you know that there are 10 primary choices here? Did you know that the

	20-Year Bond	5-Year Bond	30-Day Bill
Treasury rate	5.3%	3.6%	0.8%
RPm	7.2%	7.6%	8.6%
Assumed Beta	1.2	1.2	1.2
Assumed Beta	0.8	0.8	0.8
BUM return	12.5%	11.2%	9.4%
CAPM return (1.2)	13.9%	12.8%	11.2%
CAPM return (0.8)	11.1%	9.7%	7.7%

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range of those choices is approximately 2% to 10%?[1] With such a range of potential choices, analysts must be able to explain and support their selected assumption. The choices for RPs are all "in excess of CAPM" rate differentials as defined by Ibbotson. This means that they believe that the difference between the predicted return using CAPM and the actual return must be attributable to differences in size. This is different from the small stock risk premium, which is not beta-adjusted and is simply the arithmetic return on small stocks less the arithmetic return on the market; that is, RPm.

The risk premium (RPs) can be adjusted to reflect the type of beta calculation for the underlying portfolio of companies. The question then becomes, over what period is beta best approximated? Ibbotson provides data for betas calculated on an annual basis and on a monthly basis. Ibbotson also calculates betas that reflect the lag of market events on smaller company stocks (Sum Betas).

Assuming you agree that a beta-adjusted method is correct, the 10 choices (RPm) are as follows:

1. 10th decile monthly beta S&P
2. 10th decile annual beta S&P
3. 10th decile sum beta S&P
4. 10A monthly beta S&P
5. 10B monthly beta S&P
6. Microcap annual beta S&P
7. Microcap monthly beta S&P
8. Microcap sum beta S&P
9. 10th decile monthly beta NYSE
10. Microcap monthly beta NYSE[2]

So, which one do you use? Well, unfortunately, the answer is "it depends." First I'll explain what each one is; then I'll try to narrow down the choices to four and present their strengths and weaknesses. Then, I'll leave the decision to you.

Tenth decile annual beta means that the expected return is calculated with an annual beta. The 10th decile monthly beta is based on monthly betas. Sum beta is a lagged beta, which reflects the theory that the impact of events on smaller companies may lag the marketplace as a whole. As such, the beta in the expected return is adjusted accordingly. It is my understanding, however, that there may not be enough data points to put a lot of weight on it. Given this fact, as well as the theory that monthly betas are better than annual betas, we'll eliminate annual betas and sum betas.

THE FINAL FOUR

That leaves us with just four choices: 10th decile monthly beta, microcap quintile, 10A and 10B. Now let's get into these deciles, microcap, 10A and 10B. Ibbotson slices the New York Stock Exchange (NYSE) into 10 deciles. In the past, this was the extent of the database and included around 180 to 190 companies in each decile. In 2001, Ibbotson started to include companies of similar size from the American Stock Exchange (AMEX) and the National Association of Securities Dealers Automated Quotation System (NASDAQ). This raised the number of companies in the 10th decile to 1,724 in 2003.[3] Obviously, the other deciles increased as well, but it had the greatest impact on the 10th decile, which is the group many valuation analysts view as aligned more with the closely held companies they value.

Before this increase in the number of companies in the 10th decile, many analysts used the microcap quintile, which is just a fancy term for the ninth and 10th decile combined. The rationale was that the microcap quintile had more companies, thus more data points, thus greater reliability. We've also heard analysts say they used the microcap quintile because of "fallen angels." The fallen angels are companies that were larger in the past, or are still fairly large, but have fallen on hard times, and dropped into the 10th decile. With the addition of the AMEX and NASDAQ companies in 2001, however, many analysts shifted to the 10th decile, because it now had greater reliability as a result of the tremendous increase in the number of companies.

In 2001 Ibbotson created categories 10A and 10B. The 2004 Yearbook indicates that there are 1,158 10B companies and 554 10A companies for the period ending 2003.[4] This caused quite a commotion in the valuation community. Has the Holy Grail arrived?

Not so fast! Let's see what's behind the curtain. Sure, 1,724 companies were in the 10th decile in 2003.[5] However, let's look at the total number of companies in the 10th decile by a specific year of each decade going back to 1926, the starting point for Ibbotson's calculation of the long-term equity risk premium.[6]

Year	Number of 10th Decile Companies
1926	52
1930	72
1940	78
1950	100
1960	109
1970	865
1980	685
1990	1,814
2000	1,927
2003	1,724

1 *Stocks, Bonds, Bills, and Inflation, SBBI, Valuation Edition, 2004 Yearbook,* Ibbotson Associates, Chicago, IL, pp. 129-137.

2 Ibid. pp. 129-137.

3 Ibid. p. 132.

4 Ibid. p. 130.

5 There is no explanation of why 1,724 companies are listed on page 132 and 1,712 companies in page 130 of Ibbotson Associates *SBBI Valuation Edition 2004 Yearbook.*

6 *Stocks, Bonds, Bills, and Inflation, SBBI, Valuation Edition, 2004 Yearbook,* Ibbotson Associates, Chicago, IL, p. 132.

Only 52 companies were in the 10th decile in 1926. This means that if you split the decile in half there were approximately 26 companies in 10B.

Let's see. It does get better, but not by much. In 1930 there were 72 companies in the 10th decile with 36 in 10B, assuming an even split.

Jumping ahead to 1960, the numbers are 109 and 54 respectively. Still not enough to give comfort here. Bottom line here is that not until 1970 do we get enough companies to give the comfort we are seeking. By the way, we are not going to address the issue of whether you should look at returns from 1926 or a shorter period, say 1960 or so. That's a topic for another installment of this article.

Do you still want to rely upon 10B? Maybe not. However, is 10A, 10B or just 10 much better? Is the starting point of 52 companies for 10 so much better than 26 companies for 10B? Analysts must decide this and choose what they think they can best defend. Obviously, going the microcap or 10A route will increase the number of companies but will also put you in a size category that may be too large as compared with the closely held company being valued. If you use 10B, the companies may be more similar in size, but you have the potential problem of less data and less reliability.

Well, at least we narrowed it down to four choices. Good luck. See you in part two of this four-part article.

James R. Hitchner, CPA/ABV, ASA and Katherine E. Morris are with the Financial Valuation Group, Atlanta. Mr. Hitchner is editor of *Financial Valuation: Application & Models*, co-author of the *Financial Valuation Workbook* and of *Valuation for Financial Reporting*, all of which are published by John Wiley & Sons, Inc.

WHEN THE WHISTLE BLOWS AND THERE IS NO FOUL: MANAGING THE MISGUIDED WHISTLEBLOWER

By Paul W. Cane, Jr., and Laura N. Monfredini

The Public Company Accounting Oversight Board (PCAOB) has found that, encouraged by whistleblower protections established by the Sarbanes-Oxley Act of 2002, more people are willing to come forward to report corporate wrongdoing. Furthermore, to make it easier to report problems, the PCAOB, is opening a new hotline. CPAs should be aware, however, that sometimes employees blow the whistle for the wrong reasons. They may be mistaken or misinformed. They may also falsely accuse because they're disgruntled or trying to divert attention from their poor performance.

Employers are at risk in their response to these employees. To help minimize the risk, CPAs, their clients, and client counsel should be aware of the issues associated with unfounded whistleblowing.

The following article highlights the issues involved and describes strategies for addressing the issues. The article was written by Paul Cane, a partner, and Laura Monfredini, an associate, in the San Francisco office of Paul, Hastings, Janofsky & Walker LLP, and is based on an article that appeared in the December 2003 issue of California Employment Law Reporter.

Although the article is written from the perspective of attorneys who assist clients or management in dealing with investigations into wrongdoing, it offers lessons for CPAs who may well be at risk along with their clients who find themselves in these situations. CPAs, of course, do not offer counsel as do lawyers. However, they can play a significant role as the independent, objective investigator needed to determine if in fact fraud has been perpetrated or other related roles employers may delegate to them because they offer integrity, objectivity, and independence. As in many engagements, CPAs can team with lawyers, inside or outside the client organization, to help minimize risk and guide the client in the right direction.

In 2003, *Time* Magazine named as its "persons of the Year" three whistleblowers: Sherron Watkins (Enron), Coleen Rowley (FBI), and Cynthia Cooper (WorldCom). *Time's* accolades to the three, coming on the heels of a new federal antiretaliation cause of action for certain kinds of whistleblowers, the Sarbanes-Oxley Act of 2002 [15 U.S.C.A.§ 7201], surely will inspire emulators. Employers therefore must be ready to face a wave of internal and external whistleblowers.

But we think *Time* did not tell the whole story. What *Time* didn't mention is that for every well-intentioned and well-informed Watkins, Rowley, or Cooper, employers in the real world encounter many putative whistleblowers who are one or more of the following:

- Factually mistaken
- Legally misinformed
- Disgruntled, and motivated more by their disgruntlement than any desire to "do the right thing"
- Poor performers, blowing an internal or external whistle in an effort to inoculate themselves from workplace discipline or discharge

It is relatively easy to advise the employer when the whistleblower is *correct*; the person should be thanked, and the problem should be found and fixed. No doubt some incumbents will be embarrassed—or worse—in the process, but remember: We represent the employer, not every incumbent employee of the employer.

But what to do when the whistleblower is wrong? We offer some thoughts to consider:

The wrongly accused employer's first reaction often will be anger, and the legacy may be lack of trust. "How dare he accuse us of corporate misconduct?" officials may say. But here the employer comes to a fork in the road. Some employers will act on their emotions; the wise ones suppress them.

This is not to say that whistleblowers immunize themselves against workplace discipline. Under some statutes, complaints—at least those made through official channels—are absolutely protected. But often only good faith complaints are protected, and employers sometimes prevail as a matter of law when the employee is factually or legally wrong [see, for example, *Clark County Sch. Dist.* v. *Breedon* (2001) 532 U.S. 268, 271 (finding no protected conduct where no reasonable person could have believed that a single sexual comment constituted sexual harassment under Title VII], especially when the employee is evidently more intent on insulating himself or herself from workplace discipline or discharge than doing the right thing. When a claim is in litigation, a skilled defense lawyer often can position the case for victory—and sometimes as a matter of law on motion.

But most employers do not want to litigate precedent-setting cases or even to try to navigate safely through the litigation shoals. Most employers, mindful of the expense and risks of retaliation litigation, desire a practical solution to what has become a practical management problem. Strained relations following any internal or external complaint are inevitable and should not be minimized. Working side by side with someone who has made scurrilous allegations is fraught with tension. Yet, the cautious employer will try to manage around the problem rather than overreact. The wise company lawyer will advise the company on how safely to do that.

OSHA Publishes Final Rule on Whistleblower Procedures

On August 27, 2004, the Occupational Safety and Health Administration (OSHA) published in the *Federal Register* a final rule establishing procedures for handling whistleblower complaints under the Corporate and Criminal Fraud Accountability Act of 2002, also known as the Sarbanes-Oxley Act. This is one of 14 laws with whistleblower protections (www.osha.gov/dep/oia/whistleblower/index.html) administered by OSHA.

Here are some suggestions to consider. Every situation is different, so not every suggestion will fit every case. Sometimes the company expects litigation and will want to take steps to improve its position in that litigation. Sometimes the company will want to create an environment to negotiate an amicable arrangement. The following comprises a list of options to follow, and is not an inflexible protocol.

Say "thank you." Start dispelling any inference of retaliation by creating a record of appreciation and respect. Even if you believe the employee is wrong or misguided, the company's communications must not reflect retaliatory animus.

Watch what you say and what you write. Beware of ill-advised non-privileged communications, especially e-mail messages. A manager may simply be blowing off steam—anyone wrongly accused inevitably harbors frustration and perhaps anger—but a thoughtless e-mail message, stripped of its context, may constitute damaging evidence of retaliatory animus [see, for example, *Zubulake* v. *UBS Warburg LLC* (S.D.N.Y., May 13, 2003) 2003 U.S. Dist. LEXIS 7939 at *4 n.8 (the plaintiff "has already produced a sort of 'smoking gun': an e-mail suggesting that she be fired 'ASAP' after her EEOC charge was filed, in part so that she would not be eligible for year-end bonuses").]

Beat the whistleblower to the punch. Suppose someone has made a false, but nasty-sounding, internal allegation involving a legal compliance issue. Perhaps it is a tax issue, perhaps a regulatory issue. Consider *self*-reporting to the relevant government agency, such as the IRS, the Food and Drug Administration, the Justice Department, or the local police. Be forthcoming: "An employee has made the following allegation. We do not believe it has merit, but we do not want to conceal it, and we stand ready to cooperate in any investigation."

Such a self-disclosure accomplishes several objectives. First, it deprives the whistleblower of the ability to claim that he or she engaged in absolutely protected activity. (The internal complaint may only be qualifiedly privileged; the external complaint may be absolutely privileged.) Second, self-reporting may enhance the company's credibility with the corresponding government agency, and the additional credibility often is valuable, particularly in regulated industries. Third, the self-report deprives the individual of a theory of animus ("They fired me to prevent me from going to the feds!") Fourth, the self-report underscores that the employer was not afraid of, and indeed that it welcomed, outside scrutiny. When the employer shrugs rather than overreacts, an inference of retaliatory animus is hard to draw.

Challenge the employee to blow the whistle. This approach is a variant of beating the whistleblower to the punch. When an employee makes an internal complaint, invite him or her—indeed, almost issue a dare—to go to the authorities. "If you believe we have done something wrong, then by all means do what you think you need to do," is the message. Here again, the employer figuratively shrugs. It is hard to infer retaliatory intent if the employee does nothing more than what the employer has invited him or her to do.

Have a practice of "find it and fix it." One can manage—and defend claims by—misguided whistleblowers more easily if one has a history of responding positively when well-founded complaints are made. In addition, by establishing an internal complaint mechanism and inviting employees to exhaust this grievance procedure before filing suit, an employer also may have an additional defense to liability for retaliation or wrongful termination in violation of public policy.

Communicate in writing. Look down the litigation road and consider that it will be necessary to depose the soon-to-be plaintiff. You will be questioning him or her about all significant work events. To obtain summary judgment, you will want to eliminate all material factual disputes. Communications about key events—job options, key job directives on sensitive issues, the investigation of the merits of the whistleblowing claim, and others—all will be at issue. Communicating in writing will help avoid "he said, she said" factual disputes that impede summary judgment. In addition, written communications will provide valuable trial exhibits. Yes, initiating written communications likely will provoke responses in kind from the employee. A letter war may ensue. Keeping up the employer's end will take time. But the time is well spent; keeping the record straight from the outset is easier than setting it straight after the fact.

Commission an independent investigation. When a serious allegation is made, an internal investigation normally should occur. The company should carefully consider whether the investigation will be privileged or unprivileged. Privileged investigations have the self-evident benefit of being confidential in the event that troublesome facts are unearthed. But when the company is confident that an allegation is unfounded, the company might consider an unprivileged, on-the-record investigation (or at least proceeding with a privileged investigation intending to waive privilege eventually). To maximize the credibility of that investigation, the company might consider retaining an outside investigator so that it cannot be accused of a whitewash.

Employ lateral transfers. Sometimes a change of scenery may be mutually beneficial. Perhaps there is a lack of trust between boss and subordinate. Perhaps an unfounded allegation of misconduct is made because the employee is misinformed or ill-suited to his or her current responsibilities. In any event, a fresh start with new duties—and a new boss—may help. The company's legal interests may be advanced as well.

A lateral transfer of this sort often is not a cognizable adverse employment action, and hence not a basis for a retaliation claim. And a new boss means a new, untainted decisionmaker if the employee's performance eventually warrants disciplinary action or termination. It will be easier to defend the inevitable retaliation claim if a new, untainted decisionmaker metes out the discipline.

Change supervisors. Even if a substantive change of duties is not possible, at a minimum, consider a new boss for the reasons stated above.

Remember "Et tu, Brutus." When an adverse action is necessary, consider involving a decision maker that the prospective plaintiff likes, or at least one who is untainted and cannot readily be assailed as a retaliator.

Conduct an impartial review of any proposed adverse action. If switching to a new boss is impossible, at a minimum consider having thorough, independent fact-finding, and even *de novo* review of proposed discipline even before any adverse action is taken. When an adverse decision is investigated and reviewed from scratch, the inference of retaliatory animus is dissipated because any taint associated with the prior supervisor is removed. When the investigation and decision are too heavily influenced by facts found or recommenda-

Fraud Resources

A plethora of fraud-related resources are available through the AICPA Antifraud and Corporate Responsibility Resource Center. To get there, go to www.aicpa.org and click on "Antifraud Resource Center" in the column on the left.

Some other specific resources include the following:

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To order *The CPA's Handbook of Fraud and Commercial Crime Prevention,* call 1-888-777-7077, or visit www.cpa2biz.com.

FREE ONLINE RESOURCES

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www.aicpa.org/pubs/tpcpa/nov2003/fraud.htm

"Where to Find Fraud in Closely Held Companies," *The Practicing CPA,* November 2003

www.aicpa.org/pubs/tpcpa/nov2003/where.htm

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Roger Dodd spoke at the 2002 conference and returns this year with "Expert/Evidence/Cross-Examination," an overview of techniques you can use to reduce stress and build confidence when you're involved in any type of litigation.

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FIELDS OF STUDY: **A**-ACCOUNTING **M**-MANAGEMENT **PD**-PERSONAL DEVELOPMENT **SK**-SPECIALIZED KNOWLEDGE **T**-TAX
Topics and speakers are subject to change.

SUNDAY, NOVEMBER 7 PRE-CONFERENCE WORKSHOPS (additional fee)

7:30 am – 6:30 pm Registration & Message Center Open

8:30 am – 11:30 am **Concurrent Optional Workshops** (Select one)

101 Marketing & Managing Your Practice **M**
Barbara Oswalt, Hoyman, Dobson & Company, P.A., Melbourne, FL
John Gilbert, The Financial Valuation Group, Great Falls, MT

102 Basic Case Study: Using the Market Approach **SK**
Gary Trugman, Trugman Valuation Associates, Inc., Plantation, FL

SUNDAY, NOVEMBER 7 MAIN CONFERENCE — DAY ONE

12:30 pm Main Conference Begins

12:30 pm – 12:45 pm Welcome and Introduction
Timothy York, Dixon Hughes PLLC, Birmingham, AL

12:45 pm – 1:45 pm Keynote Presentation

1 The Capitol Steps **PD**
Sponsored by Willamette Management Associates

1:45 pm – 2:15 pm Afternoon Refreshment Break in the Exhibit Hall

2:15 pm – 3:30 pm **Concurrent Sessions** (Select one)

Hot Topic — **2** A Practical Approach to FLPs: It's Not All Gloom and Doom **SK** (repeated in session 21)
David Aughtry, Chamberlain Hrdlicka Attorneys at Law, Atlanta, GA

Core — **3** Basic Financial Ratio Analysis **SK**
G. William Kennedy, Anders, Minkler & Diehl LLP, St. Louis, MO

Hot Topic — **4** Fraud Awareness for Valuation Professionals **SK**
Robin E. Taylor, Dixon Hughes, PLLC, Birmingham, AL

Litigation — **5** Personal Goodwill vs. Practice Goodwill **SK**
Jay Fishman, Kroll Zolfo Cooper, Philadelphia, PA

3:30 pm – 3:45 pm Change Break

3:45 pm – 5:00 pm **Concurrent Sessions** (Select one)

Core — **6** Cost of Capital **SK**
Shannon Pratt, Business Valuation Resources, LLC, Portland, OR

Litigation — **7** Controversial Issues of Business Valuations in Divorce Actions **SK**
Jerome W. Karsh, Karsh Consulting, P.C., Denver, CO

Value-Added — **8** Determining the Fair Value of Intellectual Property **SK**
Jim Rigby, The Financial Valuation Group, Los Angeles, CA
Mike Mard, The Financial Valuation Group, Tampa, FL

Hot Topic — **9** The Truth About Discounts and Premiums — It's Time to Look Behind the Curtain **SK**
Jim Hitchner, The Financial Valuation Group, Atlanta, GA

5:00 pm – 5:15 pm Change Break

5:15 pm – 6:30 pm Keynote Presentation

10 Expert/Evidence/Cross-Examination **SK**
Roger Dodd, Roger J. Dodd, Lawyers, P.C., Valdosta, GA

6:30 pm – 8:30 pm Welcome Reception
Sponsored by ABV

MONDAY, NOVEMBER 8 MAIN CONFERENCE — DAY TWO

7:00 am – 6:30 pm Registration & Message Center Open

7:00 am – 8:00 am Continental Breakfast & Vendor Display

8:00 am – 9:15 am General Session

11 Stay Out of the Frying Pan!!! — Tax Valuation Issues and Case Law Update **T**
Mel H. Abraham, Mel H. Abraham, CPA, CVA, ABV, ASA, Wood Ranch, CA

9:15 am – 9:30 am Change Break

9:30 am – 10:45 am **Concurrent Sessions** (Select one)

Value-Added Service — **12** Business Damages: Lost Profits or Lost Business Value **SK** (repeated in session 16)
Brian Brinig, Brinig & Company, Inc., San Diego, CA

Core — **13** Income Approach **SK**
Bruce Bingham, BDO Seidman, New York, NY

Hot Topic — **14** Equity Risk Premium — What Valuation Analysts Need to Know About Recent Research **SK** (repeated in session 18)
Roger Grabowski, Standard & Poor's Corporate Value Consulting, Chicago, IL
Michael Barad, Ibbotson Associates, Chicago, IL

Litigation — **15** Communicating the Results **SK**
The Honorable Jack Berryhill, First Judicial District, Colorado, Golden, CO

10:45 am – 11:15 am Morning Refreshment Break in the Exhibit Hall

11:15 am – 12:30 pm **Concurrent Sessions** (Select one)

Value-Added Service — **16** Business Damages: Lost Profits or Lost Business Value **SK** (repeat of session 12)

Core — **17** Market Approach **SK**
Mike Mattson, The Financial Valuation Group, Chicago, IL

Hot Topic — **18** Equity Risk Premium — What Valuation Analysts Need to Know About Recent Research **SK** (repeat of session 14)

Hot Topic — **19** Valuation From the IRS Perspective — A Whimsical Yet Serious Review of Recent Cases, Regulations, and Other Issues in the Area of Estate & Gift Tax **T**
Marty Basson, Internal Revenue Service, Plantation, FL

12:30 pm – 1:30 pm Luncheon & Awards

1:30 pm – 1:45 pm Change Break

Conference agenda National Business Valuation Conference

1:45 pm – 3:00 pm — **Concurrent Sessions** (Select one)

Hot Topic — **20 Meet the Thought Leaders SK**
(repeated in session 24)
Participating Leaders: Neil Beaton, Mel Abraham, Robert Reilly, Ed Dupke, Nancy Fannon, Butch Williams, Bob Duffy, Barry Sziklay, Tom Hilton, Mike Crain and many more.

Hot Topic — **21 A Practical Approach to FLPs: It's Not All Gloom and Doom SK** (repeat of session 2)

Hot Topic — **22 Adjusted Present Value (APV Method) SK**
Mark Zyla, Acuitas, Inc., Atlanta, GA

Core — **23 Internet Research SK**
Eva Lang, Financial Consulting Group, Germantown, TN

3:00 pm – 3:15 pm — **Change Break**

3:15 pm – 4:30 pm — **Concurrent Sessions** (Select one)

Hot Topic — **24 Meet the Thought Leaders SK** (repeat of session 20)

Core — **25 Discounts & Premiums SK**
Barry S. Sziklay, Cipolla Sziklay L.L.C., West Orange, NJ

Value-Added Service — **26 FAS 141/142 Case Study A**
Arron Gilcreast, Standard & Poor's, Atlanta, GA

Hot Topic — **27 Nonsystematic Valuation Discount/Premium Adjustments: Company-Specific Adjustments, Security-Specific Adjustments, and Application of Multi-Tier Adjustments SK**
Robert Reilly, Willamette Management Associates, Chicago, IL

4:30 pm – 5:00 pm — **Afternoon Refreshment Break in the Exhibit Hall**

5:00 pm – 6:30 pm — **General Session**

28 Business Valuation Standards & AICPA Update SK
Ed Dupke, The Rehmann Group, Grand Rapids, MI
Michael A. Crain, The Financial Valuation Group, Ft. Lauderdale, FL

TUESDAY, NOVEMBER 9 MAIN CONFERENCE — DAY THREE

7:00 am – 1:30 pm — **Registration & Message Center Open**

7:00 am – 8:00 am — **Continental Breakfast & Vendor Display**

7:00 am – 8:00 am — **201 Town Hall Meeting SK**
Michael A. Crain, The Financial Valuation Group, Ft. Lauderdale, FL

8:00 am – 8:15 am — **Change Break**

8:15 am – 9:30 am — **Concurrent Sessions** (Select one)

Hot Topic — **29 Integrated Business Valuation Theory SK**
Z. Christopher Mercer, Mercer Capital Management, Inc., Memphis, TN

Value-Added Service — **30 Fair Value and Goodwill Impairment A**
Mike Mard, The Financial Valuation Group, Tampa, FL

Hot Topic — **31 Ethics: Avoiding Valuation Malpractice E**
Robert R. Harris, Harris Cotherman Jones & Price CPAs Chartered, Vero Beach, FL
Warren Hutchison, Donovan Hatem, LLP, Boston, MA

Value-Added Service — **32 Mergers & Acquisitions A, SK**
Neil J. Beaton, Grant Thornton LLP, Seattle, WA

9:30 am – 9:45 am — **Change Break**

9:45 am – 11:00 am — **Concurrent Sessions** (Select one)

Hot Topic — **33 Niche Vignette: The Valuation of Healthcare Services Businesses SK**
Greg Koonsman, Value Management Group, L.L.C., Dallas, TX

Hot Topic — **34 Niche Vignette: Professional Services SK**
Thomas E. Hilton, Anders Minkler & Diehl LLP, St. Louis, MO
Gary Trugman, RCH Trugman Valuation Associates, Ft. Lauderdale, FL

Hot Topic — **35 Niche Vignette: Software and High-Tech Companies: Insights and Valuation Issues SK**
Jim Rigby, The Financial Valuation Group, Los Angeles, CA

Hot Topic — **36 Niche Vignette: Construction SK**
Don M. Drysdale, Yeanoplos Drysdale Group, PLLC, Tucson, AZ

11:00 am – 11:30 am — **Morning Refreshment Break in the Exhibit Hall**

11:30 am – 1:30 pm — **General Session**

37 Valuation of Pass-Through Entities: The Plot Thickens SK
Moderator: Nancy Fannon, Fannon Valuation Group, Portland, ME
Panelists: Z. Christopher Mercer, Mercer Capital Management, Inc., Memphis, TN
Daniel Van Vleet, Willamette Management Associates, Chicago, IL
Chris D. Treharne, Gibraltar Business Appraisals, Inc., Longmont, CO

1:30 pm — **Conference Adjourns**

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2:15 pm – 3:30 pm	☐2	☐3	☐4	☐5
3:45 pm – 5:00 pm	☐6	☐7	☐8	☐9

MONDAY, NOVEMBER 8 — **Concurrent Sessions**

9:30 am – 10:45 am	☐12	☐13	☐14	☐15
11:15 am – 12:30 pm	☐16	☐17	☐18	☐19
1:45 pm – 3:00 pm	☐20	☐21	☐22	☐23
3:15 pm – 4:30 pm	☐24	☐25	☐26	☐27

TUESDAY, NOVEMBER 9 — **Concurrent Sessions**

7:00 am – 8:00 am	☐Town Hall Meeting			
8:15 am – 9:30 am	☐29	☐30	☐31	☐32
9:45 am – 11:00 am	☐33	☐34	☐35	☐36

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CPA2-0719 G50024

Whistleblower Claims Mostly Unsuccessful

Sarbanes-Oxley whistleblower complaints outnumber other types of whistleblower complaints according to the Department of Labor (DOL). Even so, most claims do not prevail. Sarbanes-Oxley-related claims are administered by the DOL's Occupational Safety and Health Administration (OSHA), which administers all federal whistleblower cases. Thus far, 307 employees filed Sarbanes-Oxley-related complaints. Of the 228 claims filed as of April, 2004, OSHA dismissed 156 claims, more than 80 percent of those claims. On appeal, only two of 43 cases were resolved.

Lack of merit, however, is not the reason for dismissal in most cases. Some cases failed because complainants missed the 90-day deadline to file or because the statute is not retroactive.

When a statute is new, the dismissal rate tends to be high also because complainants and their lawyers tend to test the statute's limits. Furthermore, Sarbanes-Oxley, like several other laws administered by the DOL, requires plaintiffs to plead a *prima facie* discrimination case when they make their claims. "The prima facie standard is a high barrier at such an early stage, because most complainants either lack the legal know-how to put together a proper complaint or have not yet had a chance to uncover facts that would support a *prima facie* showing," said Christopher J. Wesser, an attorney with Moran Kiker Brown PC, Richmond, Virginia, who is experienced in litigating whistleblower cases before the DOL. Consequently, "an unreliably high percentage of complaints" are dismissed at the initial, investigatory stage. Wesser warns that the numbers "neither accurately reflect the ultimate outcomes in cases that begin with an OSHA investigation, nor adequately portray the true risk to a company that finds itself the target of a Sarbanes-Oxley whistleblower complaint."

tions made by the supervisor, the benefit of this approach may be lost.

Be patient. Time heals all wounds, the saying goes. The employment-law corollary is this: Retaliators retaliate; they do not forbear. The cases recognize that any erroneous influence of retaliation dissipates with time.

Consider the optics of coincidences of timing. Coincidences of timing, without more, do not even create triable questions of retaliation, and employers need not suspend actions "in the works" just because some legally protected activity intervenes. In *Clark County Sch. Dist.* v. *Breeden* (2001) 532 U.S. 268, 272, for example, the Supreme Court said that "Employers need not suspend previously planned transfers upon discovering that a Title VII suit has been filed, and their proceeding along lines previously contemplated, though not yet definitively determined, is no evidence whatever of causality." Even so, the optics of timing may mislead or confuse jurors. Weigh the benefits of prudent forbearance against the importance of taking immediate adverse action.

Give credit where credit is due. When praise is owed, offer it. When good work is done, reward it. Intervening "nice things"—especially coming from a supervisor previously tainted by allegations of impropriety—help dispel an inference of retaliation.

Diffuse constructive discharge allegations. When a whistleblower quits, odds are that a constructive discharge lawsuit is forthcoming. Immediately put counter measures into effect. Consider sending the terminating employee a written communication (a "valentine") inviting him or her to reconsider. The "valentine" might promise an independent review of the circumstances that allegedly prompted the resignation—and the employer should follow through on that promise if the individual returns. Consider offering him or her a transfer or even a choice of jobs or bosses. Assure that there will be no retaliation, and perhaps explain that a monitor, reporting to a named senior executive outside the normal chain of command (for example, the Senior Vice President for Human Resources) will follow through to ensure that no retaliation occurs. Ask for a prompt response, but make clear that if for any reason the individual needs more time, he or she should ask for it. If the whistleblower refuses to return in the face of such a "valentine" with some or all of these elements, the constructive discharge claim normally will be disproved as a matter of law.

Consider a severance package—but only as a last resort. Severance packages have their place, but they should be a last resort, not the first. "Packages" too often put a Band-aid on bad management. Tense whistleblower situations may end in packages, but the package will be most reasonable if the employer follows the suggestions set forth above, demonstrates patience, and secures negotiating leverage by improving the employer's position on the merits.

One special aspect of the severance ritual merits comment. Take careful steps to ensure that the severance offer does not become adverse evidence. ("They wanted me out. Look at the piece of paper they shoved at me.") Make clear that severance is an option, not a requirement. Emphasize that the individual has a job (or choice of jobs) and is invited to perform it. Severance should be clearly described as a voluntary choice for the employee, in the event that the severance offer is deemed admissible. Consider, for example, *Cassino* v. *Reichold Chem.* (9th Cir. 1987) 817 F 2d 1338, 1348, in which the jury found that willful age discrimination was supported by substantial evidence in that "the termination agreement that [the defendant] offered [the plaintiff] specifically required [the plaintiff] to waive his right to sue for age discrimination in return for severance pay."

Have a predispute arbitration agreement. Arbitrating whistleblower claims is cheaper, and the outcome fairer and more predictable, than trying the cases to juries. But that is a subject for another day.

Paul Cane is a partner and Laura Monfredini is an associate in the San Francisco office of Paul, Hastings, Janofsky & Walker LLP. They represent employers in all aspects of employment law, including the defense of whistleblower and retaliation claims. Mr. Cane briefed and argued one of the seminal California retaliation and constructive discharge cases, *Turner* v. *Anheuser-Busch, Inc.* (1994) 7 Cal. 4th 1238.

In the KNOW

By James R. Hitchner, CPA/ABV, ASA

Welcome to my new column, which will address contemporary issues in the business valuation world. I'll try to keep you abreast of the latest data, theories, techniques, applications and models in this quickly evolving service line area. I'll also try to keep it practical and simple, not always an easy task in business valuation.

Did you know that 6% is an important number? Why, you ask? Because this is what many economic forecasters are predicting to be the average annual nominal (inflation and real) growth rate for the economy for the next ten years. This is made up of 2.5% inflation and 3.5% real GDP growth (Livingston Survey, December 2003, Federal Reserve Bank of Philadelphia). Did you also know that the average nominal growth rate of the U.S. economy since the late 1920s has been around 6.5% (about 3% inflation and 3.5% real GDP), obviously fairly close to 6%? This makes 6% a powerful force to be reckoned with when determining the perpetual growth rate in either a capitalization rate in a capitalization of cash flow model or the terminal year of a discounted cash flow model.

Why is 6% such a powerful force? Because many companies and many industries mirror the performance of the U.S. economy and thus their normalized growth rates may be very similar. Furthermore, in a capitalistic society, it is difficult to sustain high growth, i.e., above the nominal GDP growth rate for long periods of time, let alone into perpetuity. Is 6% the end-all? No. You still need to look at historical performance, industry analysis, projections, etc. to determine a growth rate. However, 6% could be a good starting point or at least a benchmark to consider, when choosing a company's anticipated long-term average growth rate in certain industries.

DISCUSSION MEMORANDUM ON FORENSIC ACCOUNTING SERVICES

An opportunity for practitioners' to weigh in on their guidance needs.

The AICPA Forensic and Litigation Services (FLS) Committee has developed a discussion paper called *Forensic Services, Audits, and Corporate Governance: Bridging the Gap*. The paper provides the FLS Committee's initial observations and views concerning forensic accountants' services, including involvement with the independent audit team to increase financial statement audit effectiveness and execute accounting-related fraud investigations. This paper also raises important questions about what guidance—in addition to Statement of Auditing Standards No. 99 (SAS99), *Consideration of Fraud in a Financial Statement Audit*—may be needed to assist forensic accountants and auditors to enhance the validity, reliability, consistency, and transparency of audit work and related results.

A CHANCE TO COMMENT

The purpose of the discussion paper is to obtain comments from auditors, forensic accountants, managerial accountants, standard-setting and regulatory agencies, and other stakeholders, before guidance is developed. In addition, the FLS Committee will sponsor a roundtable on September 22, 2004 at the National Press Club in Washington, D.C. to discuss the nature of additional guidance that may be needed.

An executive summary of the paper is available at www.aicpa.org/members/div/mcs/exec_summ_forensic_svcs.htm, with a link to the complete discussion paper. The FLS Committee is seeking questions, comments, and suggestions by October 15, 2004.

Best Business Valuation Practices

The AICPA will launch a new Business Valuation and Fraud and Litigation Services Web site soon and is seeking "best BV practices tips" to make available to new business valuators.

The Institute is also seeking testimonials from ABV credential holders about what the ABV has meant to you or how it has improved your business. Please forward to Jessica V. Dunlap Yazujian, Sr. Manager, ABV Credential and BV/FLS Membership Section, at jdunlap@aicpa.org.

Q&A: THE QUESTION OF CONTINGENCY FEES

Questions from members on business valuation and forensic and litigation services; answers from AICPA professional staff

By James Feldman, CPA/ABV, MBA and Eleonora Tinoco

The AICPA's Business Reporting and Member Specialization Team, Business Valuation and Forensic & Litigation Services division answers questions from AICPA members as one of its services to members. Because several members may have the same questions, we publish some of our responses here.

QUESTION:

Can I accept a contingent fee from a client if I perform a business valuation service, litigation service, or some other type of consulting service for that client?

ANSWER:

Before responding, we would like to point out that this is technically a "compound question." In a legal setting, this type of question should not be answered because the response could be confusing and ambiguous. Instead, the question should be rephrased into a series of questions for each type of service. The reason for this is that the response may be different, depending upon whether we are talking about a business valuation service, a litigation service, or other consulting service. (We just thought we'd include that tip on expert testimony.)

In this case, the answer isn't a simple "yes" or "no" even if we break the question down because the answer depends upon the nature of the service to be performed, the practitioner's professional affiliations, and the regulatory environment. But before we tackle these issues, let's identify the definition of a contingent fee, according to the AICPA rules.

AICPA RULES

As stated in ET [Ethics] Section 302.01 *Contingent Fees* from the *AICPA Professional Standards: Code of Professional Conduct and Bylaws:*

> *Except as stated in the next sentence, a contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. Solely for purposes of this rule, fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.*
>
> *A member's fees may vary depending, for example, on the complexity of services performed.*

With this definition, I'll describe some examples of various consulting services compensated by contingency fees, without commenting at this point whether or not they are permitted and under what circumstances.

EXAMPLES

1. *An economic damages analysis.* A member is asked by an attorney, who is representing the plaintiff, to perform an economic damages analysis and to prepare a report in connection with a breach of contract claim. The attorney believes that the plaintiff's case is very strong and will settle before it comes to court. The attorney asks if the member is willing to be paid $10,000 in advance plus 5 percent of the settlement amount. The attorney has taken the case on a contingency fee of 35 percent and believes that the settlement will be approximately $3 million.
2. *A variant of example no. 1.* Assume the same facts as in example no. 1, but with a different compensation arrangement for the member. In this case, the attorney asks if the member is willing to be paid $8,000 in advance plus 3 percent of the amount of damages estimated in the member's final report. In the "highly unlikely" event that the case goes to trial, the member would be paid $2,000 per day for the court appearance.
3. *Forensic investigation.* A corporation believes that several vendors have been overcharging for various services. An attorney representing the corporation wants to engage the member to perform a "forensic accounting" analysis of billing and other documentation. The attorney asks if the member would accept a 35 percent contingent fee on any settlements with the vendors for overcharges, in lieu of the member's usual hourly fee.
4. *The business broker.* A member is asked to serve in the role of a business broker, arranging the sale of a privately held business. While the commission for this service can vary, a business broker might earn a rate in the neighborhood of 10 percent of the selling price at the closing of the sale.
5. *Valuation analysis.* A member is asked by the seller to perform a business valuation and to prepare a valuation report in connection with the sale of a chain of retail clothing stores to another buyer. The seller asks if the member is willing to be paid a fee of 1.5 percent of the member's valuation estimate in the final report, in lieu of an hourly or flat rate fee. Preliminary indications suggest that the business could sell for $10 million.

Now, let's discuss the specific AICPA rules that apply to these examples, and then we'll cover some issues and other rules that may be involved. Here are the pertinent parts of the rule from ET [Ethics] Section 302.01 Rule 302—Contingent fees:

A member in public practice shall not

(1) Perform for a contingent fee any professional services for, or receive such a fee from a client for whom the member or the member's firm performs,

(a) an audit or review of a financial statement; or

(b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or

(c) an examination of prospective financial information

...The prohibition in (1) above applies during the period in which the member or the member's firm is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in any such listed services.

Note that Rule 302 permits the member to accept a contingent fee from clients for whom no "attest services" (as defined) are performed. The prohibition on contingency fees is dependent upon *other audit and accounting services* that the member or the member's firm performs or has performed for the same client—*not* the nature of the service to be performed for a contingent fee. In other words, the AICPA rule does not contain any specific prohibitions against accepting a contingent fee for performing a business valuation, a litigation service, or any other consulting service.

With respect to examples 1, 2, and 3, you may ask: "Does the fact that an attorney—rather than the attest client—is hiring or paying the member for the consulting service on a contingency basis mean that Rule 302 does not apply?" ET Section 92.03 defines *client* as "any person or entity, other than the member's employer, that engages a member or a member's firm to perform professional services or a person or entity with respect to which professional services are performed." Thus, assuming the attest client is the "person or entity with respect to which the professional [consulting] services are performed," Rule 302 should apply, and the attorney is considered the agent of the client.

Also note that Rule 302 (1) (c), ["an examination of prospective financial information"] might initially suggest that the member cannot accept a contingency fee for a business valuation or litigation service if—as part of the service—the member develops or prepares prospective cash flows or earnings (for example, develops the forecasts for use in the discounted cash flow or "DCF" method). However, in our examples the member is engaged to perform a business valuation or litigation service, rather than an examination of prospective financial information, and, therefore provision (1) (c) does *not* apply here. If the member were *specifically engaged* to perform an examination of the prospective financial information, however, then provision (1) (c) would prohibit the member from accepting a contingent fee.

Another observation about Rule 302 is that a "commission" could be considered a type of contingent fee, as defined in the rule. In example no. 4, the member is asked to serve in the role of a business broker and would receive a commission of about 10 percent for arranging the sale of a privately held business. In this example, the "commission" is a "contingent fee" because the amount of the member's fee is "dependent upon the...result of such service." Why might this be significant? The reason is that there is a separate rule, ET Section 503, *Commissions and Referral Fees*. Fortunately, we need not be concerned in this case because the prohibited commissions in Rule 503.01 essentially mirror provisions (1) (a), (b), and (c) in Rule 302.01.

So, to recap, Rules 503 and 302 would not specifically prohibit the fee arrangements contemplated in any of our five examples if the client is a non-attest client. There are, however, other AICPA rules to consider. All members, for example, are required to comply with ET Section 54, *Article III—Integrity*. ET Section 54.03 states:

Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance, or in the face of conflicting opinions, a member should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?" Integrity requires a member to observe both the form and spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment.

All members should also maintain objectivity and be free of conflicts of interest. As defined in this pertinent excerpt from ET Section 55.01:

Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligations to be impartial, intellectually honest, and free of conflicts of interest.

The contingent fees in examples no. 3 and no.4 do not appear to present any issues with respect to the AICPA principles of integrity and objectivity. In example no. 3, the member can earn a higher fee by identifying more instances of overcharges, but that fact in itself does not pose any ethical concerns, particularly from the perspective of the vendors that have overcharged the client corporation. In example no. 4, the member can earn a higher total commission if the sale price of the business is higher, but since the member is not rendering an opinion or conclusion of value of the business, the fee arrangement does not in itself appear to pose ethical concerns.

But how do examples no. 1, no. 2, and no.5 measure-up against the integrity and objectivity benchmarks? In example no.1, the member is asked to prepare an economic damages report and the member stands to take a higher fee if the actual settlement is higher, even though that amount will not be known at the time the member issues the report. In example no.2, the member stands to take a higher fee if the economic damages in the member's report are higher. Similarly, in example no. 5, the member also stands to collect a higher fee if the estimated value of the business in the report is higher. Because of the incentives involved, the member accepting such engagements may be characterized as an advocate for the client or a "hired gun," rather than an "advocate for a position." Of course, in litigation matters, such fee arrangements, when discovered, could easily be used by opposing attorneys to discredit the member.

OTHER RELEVANT RULES, LAWS, AND CONSIDERATIONS

In addition to AICPA rules, the member also has to consider other entities in the regulatory environment. If the AICPA member is performing a business valuation and is a member of certain other business valuation organizations, then he or she is also subject to the standards of those other organizations: the American Society of Appraisers, the Institute of Business Appraisers, and the National Association of Certified Valuation Analysts. Each has *specific* provisions in its standards that prohibit members from performing a valuation resulting in a conclusion or opinion of value for a contingent fee. Therefore, their standards prohibit the fee arrangement in example no. 5, but appear to permit a contingent fee in the "business broker" case in example no. 3.

You may ask: "Why not include 'an engagement in which the member renders an expert opinion or an opinion of value'—or words to that effect—in addition to the 'attest' services cited in Rules 302 and 503, when describing services for which contingent fees (or commissions) are prohibited?" Such a provision would make for a clear-cut "yes" or "no" response for each example, at least with respect to the AICPA ethical aspects of the question. The reason is that the specific language in Rules 302 and 503 was based upon a Federal Trade Commission (FTC) consent order, issued July 26, 1990. Under the FTC order, the AICPA agreed, *inter alia,* not to restrict CPAs from working for clients for contingent fees if they are not performing audits (or other services involving attestation) for them. At that time, apparently, engagements involving an opinion of value or an expert opinion weren't considered.

In addition to the AICPA rules and the standards of other organizations, members also need to recognize that state governments, state boards of public accountancy, and state societies may have their own rules having an impact not only on the contingent fee issue, but also on the type of work a CPA may perform. These entities may have more restrictive rules, additional requirements (for example, detailed written disclosure), or both.

Another consideration is that if the member is serving as a "business broker" for the *asset sale* of a nonattest client's business, and the business happens to include real estate, the member may need to be licensed to perform this service. New Jersey law, for example, permits only licensed realtors to receive a commission involving the sale of real estate.

Also, although most states currently do not have specific business broker licensing requirements, the member needs to be aware of the applicable state law on this issue as well.

In addition, if the member is paid a commission in connection with the purchase or sale of securities (such as corporate stock and limited liability company interests), the member is deemed to be a "broker," and the member is required to be licensed as a registered representative in accordance with the Securities and Exchange Commission (SEC) rules. For further information, see the SEC Web site, Division of Market Regulation: Exchanges, Other Markets, Broker-Dealers, Clearing Agents, and Transfer Agents: www.sec.gov/divisions/marketreg.shtml.

Finally, members need to be aware that many insurance companies specifically exclude coverage for client services performed by CPAs when they receive a commission or contingent fee.

SUMMING UP

Before accepting an engagement on a contingent fee basis, a member needs to consider the nature of the service to be performed, professional affiliations, and the regulatory environment, including AICPA rules and those of state governments, state boards of public accountancy, state societies, and federal agencies.

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Letters to the Editor

***CPA Expert* encourages readers to write letters on issues related to business valuation and litigation and dispute resolution services and on published articles. Please include your name and telephone and fax numbers. Send your letters by e-mail to** wmoran@aicpa.org.

FYI...

2004 MEDICAL GROUP COMPENSATION & FINANCIAL SURVEY RESULTS PUBLISHED

Most physician specialties saw modest increases in compensation in 2003, according to findings of the American Medical Group Association's (AMGA) 2004 Medical Group Compensation & Financial Survey. Over the past four years, median compensation and gross productivity for physicians has generally increased. During 2003, however, only certain high demand specialties saw major increases in median compensation.

Demand for surgical and medical specialists increased, balanced by decreased demand for primary care physicians. For the period 2003–04, the survey found that physicians specializing in cardiology (9.19 percent–11.97 percent), dermatology (16.71 percent), gastroenterology (12.34 percent), and pathology (13.51 percent) experienced the largest increases in compensation.

Among the specialties that have seen the lowest increases over the past year are neurology (1.67 percent), general surgery (0.33 percent), and orthopedic surgery (1.24 percent). During the past four years (2000–03), the rate of increase has been particularly low in some specialties: for example, family medicine (7.05 percent), neurology (6.28 percent), gynecology and obstetrics (4.61 percent), and orthopedic surgery (4.12 percent).

Concerning financial operations, medical groups in the Northern Region operate with an average loss of $3,477 per physician (median performance per physician). Groups in the Southern Region on average made a modest $570 per physician, while groups in the Eastern and Western regions performed better at $2,080 and $1,530 per physician, respectively.

The AMGA's 2004 Medical Group Compensation & Financial Survey includes salary and productivity data on physicians in 98 specialties, 25 other health care provider positions, and 20 administrative positions, broken down by group size, location, and total relative value units, a standard method of determining productivity. The survey contains compensation and productivity data from approximately 30,500 U.S. medical group physicians and is designed to help managers compare current physician compensation and productivity levels, and trends, as well as relationships between compensation and productivity. AMGA's Web site is www.amga.org.

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